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No. 87-.....

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

CHURCH OF SCIENTOLOGY OF CALIFORNIA,

Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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Questions Presented

1. (A) Whether a church may be denied tax exempt status under section 501(c)(3) of the Internal Revenue Code because it vigorously promotes the sale and dissemination of its religious scriptures, while paying royalties (acknowledged to be reasonable by the Internal Revenue Service) to the author of the scriptures, the founder and spiritual leader of the religion?

(B) Whether denial of tax exempt status for the reason stated in 1(A) violates the Church's rights under the Religion Clauses of the First Amendment and threatens the rights of all churches to proselytize through the sale of religious literature?

2. (A) Whether a church may be denied tax exempt status under section 501(c)(3) of the Internal Revenue Code because it requires that all officially sanctioned religious works be copyrighted in the name of the founder and spiritual leader of the religion, and where the founder does not receive royalties on works authored by others but copyrighted to him?

(B) Whether denial of tax exempt status for the reason stated in 2(A) violates the Church's rights under the Religions Clauses of the First Amendment by fostering continuing and intrusive administrative entanglement in the internal affairs and policies of all churches?

3. (A) Whether a church may be denied tax exempt status under section 501(c)(3) of the Internal Revenue Code because assets of the church are in the control of a church's spiritual leader who has no official corporate responsibility for managing church assets, in the absence of any evidence of a transaction benefitting the church leader personally.

(B) Whether denial of tax exempt status for the reason stated in 3(A) creates serious violations of churches' rights under the Religion Clauses by requiring the Internal Revenue Service to intrude into internal religious practices and decisionmaking and draw distinctions for tax purposes based on how churches choose to hold their funds and with what degree of formality their religious leaders exercise authority?

Parties to Proceedings Below

The parties to the proceedings below were the petitioner Church of Scientology of California and the respondent Internal Revenue Service.

Petitioner Church of Scientology of California has no parent companies, subsidiaries, or affiliates to list pursuant to Rule 28.1.

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Church of Scientology of California (the "Church") respectfully petitions that a writ of *certiorari* issue to review the opinion of the United States Court of Appeals for the Ninth Circuit, entered in the above-entitled proceeding on July 28, 1987.

Opinions Below

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 823 F.2d 1310, and is reprinted in the appendix hereto (App. A, A1-A25). The opinion of the United States Tax Court is reported at 83 T.C. 381, and is reprinted in the appendix (App. B, B1-B146).

Jurisdiction

The judgment of the court of appeals was entered on July 28, 1987 (App. D, D1). An order denying petitioner's petition for rehearing and suggestion for rehearing *en banc* was filed October 19, 1987. (App. C, C1). On December 31, 1987, Justice O'Connor ordered that the time for filing this petition for writ of *certiorari* be extended to and including February 16, 1988. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

Constitutional and Statutory Provisions Involved

The First Amendment to the Constitution of the United States provides in pertinent part:

> Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof. . . .

The Fifth Amendment to the Constitution of the United States provides in pertinent part:

> No person shall . . . be deprived of life, liberty, or property, without due process of law. . . .

26 U.S.C. § 501 of the Internal Revenue Code (as in effect in 1970, 1971, 1972) provides in pertinent part:

> (a) *Exemption from taxation.* An organization described in subsection (c) . . . shall be exempt from taxation under this subtitle. . . .
>
> * * *
>
> (c) *List of exempt organizations.* The following organizations are referred to in subsection (a):
>
> * * *
>
> (3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for re-

ligious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

Statement of the Case

Petitioner Church initiated this proceeding in the United States Tax Court challenging federal income tax deficiencies and late-filing penalties asserted by respondent Commissioner for the tax years 1970, 1971 and 1972.

The Church was incorporated as a non-profit corporation in California on February 18, 1954. The Church was, and is, organized exclusively for religious purposes within the meaning of Section 501(c)(3) (App. B5), and its purpose is to practice and propagate Scientology, which was founded in the 1950s by L. Ron Hubbard (*id.*). It is undisputed that "Scientology is an international religion with numerous churches around the world." (App. A6). On January 2, 1957, the Internal Revenue Service (IRS) recognized the Church's tax-exempt status as an organization described in Section 501(c)(3) (App. B23).

The writings and recorded statements of L. Ron Hubbard, the founder of the religion of Scientology, constitute the scriptures of Scientology (RT 8821-22, 476-79, 459).[1]

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[1] "RT" references are to the pages of the reporter's transcript of proceedings before the United States Tax Court. "CR" refers to documents in the Tax Court Clerk's record as numbered in the certified index transmitted to the court of appeals.

Mr. Hubbard's writings as a whole "stand as an authoritative text, the foundational document of the Church of Scientology" (RT 479). His writings are the source of the religion, and it is only by direct study of these writings that any adherent can understand the religion or derive benefit from it. Thus Scientology ministers are enjoined never to neglect an opportunity to direct parishioners to Mr. Hubbard's writings, rather than try to characterize doctrine in their own words. (*See* Ex. 24-X, Vol. IV, pp. 141-42). And the clergy is directed to supervise parishioners' study of the Hubbard writings, rather than engage in instruction (Ex. 24-X, Vol. IV, p. 190).

The overwhelming majority of the religious literature sold by the Church was written by Mr. Hubbard (RT 2966-67), and those small portions written by others were derivative of Mr. Hubbard's writings. The scriptural work of Mr. Hubbard consists of over 25 million words, in writings and recorded statements (RT 293; Ex. 272-73). The Church actively sought to sell this religious literature, thereby disseminating the doctrines of Scientology and propagating its religious beliefs.

Mr. Hubbard held copyrights on published Scientology literature and received royalties from the Church from the sale of some of the literature during 1971 and 1972. These royalty payments were accepted by the IRS as reasonable and necessary expenses of the Church. *See* Ex. 3-C for 1972; Ex. 187, pp. 74-75, Ex. DX, Stip. No. 2, p. 4 and Schedule B of the Notice of Deficiency for 1971. There is no evidence that Mr. Hubbard received royalty payments from the Church in 1970. (Stip. No. 2 (CR 50), ¶¶ 1, 2, 6, 8, 9).

High Church officials periodically sent out ecclesiastical directives and administrative guides which were used by Church personnel to operate Scientology organizations and ensure adherence to religious doctrine. The most important of these were Hubbard Communications Office Policy Let-

ters (HCO PL). The vast majority of these policy letters were written by Mr. Hubbard, and the ones which were written by others were derivative of policy and doctrinal writings of his. *See, e.g.*, Ex. 24-X, Vol. VII, p. 586, a policy letter not written by Mr. Hubbard but explicitly relying on writings of Mr. Hubbard. These Policy Letters are part of the scriptures of the religion (RT 476-79, 459-60, 481, 8833-34, 8871). The Church collected and published some Policy Letters in a nine-volume work called the OEC (Ex. 24-X; RT 354-55, 357-58), and paid Mr. Hubbard royalties on its sale of these volumes in the tax years 1971 and 1972.

According to a Church policy of longstanding, all Church-sanctioned works about Scientology had to be copyrighted to Mr. Hubbard (App. B13). Pursuant to this policy, Mr. Hubbard held copyrights on some religious literature sold by the Church and authored by others. Two such books copyrighted to Mr. Hubbard were "Know Your People," written by Ruth Mitchell, and "How to Be Successful," written by Peter Gillum. Contrary to the statement of the court of appeals (App. A9), the Church did not pay royalties to Mr. Hubbard from sales of these books. *See* ¶ 6 and Exhibit 3 to Stip. No. 2 (CR 50), a complete list of the materials on which the Church made royalty payments to Mr. Hubbard during the years in issue, which does not include these works.

During 1970 through 1972, Mr. Hubbard and his wife Mary Sue Hubbard lived aboard the ship *Apollo*, which at that time served as the Church's ecclesiastic and administrative headquarters—called the Flag Division (App. B8). Also on board were some 300 other Scientologists (RT 1815), all of whom were members of a religious order of highly trained Scientologists dedicated to the advancement and dissemination of the religion. Although Mr. Hubbard had resigned his position as executive head of the church in 1966 (App. A8), he continued to provide the spiritual leadership of the Church. He continued his

Scientology research aboard the *Apollo* during the years at issue, developing new religious rites and new training courses and course material, and assisting senior Flag staffers in the operation of Flag as the highest ecclesiastical authority in Scientology (Exs. 272, 273; Ex. 187, pp. 81-83; Ex. 112, "COMMAND" sections of OODs; RT 8828-32).

Mary Sue Hubbard was Controller of the Church (Ex. 187 at 50), and, as Guardian, had ultimate responsibility for the defense and propagation of Scientology (Ex. 47; RT 907-08; 5808-09, 8967-70).

Prior to and during the years in issue, the Church made contributions to the United States Churches of Scientology Trust. Mr. Hubbard was trustee of this trust, whose purpose was the defense and propagation of the religion of Scientology. In 1972, approximately one million dollars was transferred from the Trust accounts to a safe aboard the *Apollo*, to which Mrs. Hubbard, the Church official responsible for defense and propagation of the religion, maintained the key. During the years in issue, funds of the Flag Division were maintained in bank accounts of the Operation Transport Corporation ("OTC") (*See* App. A10). In 1972, the Board of Directors approved a transfer of two million dollars from OTC accounts to the safe on the *Apollo*, to which Mrs. Hubbard maintained the key. There is no evidence in the record that funds from OTC, the Trust or other trust funds were brought aboard the *Apollo* in 1970 or 1971.

There is no evidence in the record that Mr. or Mrs. Hubbard used any of the Trust or OTC funds transferred to the ship in 1972 for their private benefit (RT 5153),[2] and indeed, that they were spent at all. To the contrary, Derek Field, a Trust accountant, testified that in 1973 he physically counted aboard the *Apollo* all the cash taken

[2] Ex-Scientologist John McLean, a government witness, who was on the *Apollo* in 1971 and 1972 and who claimed to be familiar with the income information statistics of Scientology organizations around the world, *see* RT 5163-64, testified that he never saw a check made out to Mr. Hubbard. RT 5153.

aboard from Trust accounts and kept by Mrs. Hubbard and that none was missing (*See* RT 1281-87, 1478-88). The placing of these funds in a secure place under the control of Mrs. Hubbard is hardly surprising since she was the Controller of the Church. As previously noted, Mrs. Hubbard was also responsible as head of the Guardian's office for defense and propagation of the religion, the explicit purpose for which the Trust funds were intended.

The record reflects that pursuant to a policy letter dated September 7, 1972, HCO PL 7 September 1972 (Ex. 30), calling for debt repayments to Mr. Hubbard, some $19,324.41 was received between October 9, 1972 and December 28, 1972.[3] There is no evidence in the record of debt repayments to Mr. Hubbard in 1970 or 1971. IRS witness McLean specifically testified that he had no evidence of debt payments prior to September 7, 1972 (RT 5237).

Procedural History

Respondent asserted federal income tax deficiencies and late-filing penalties against the Church in the amount of $1,438,073.58 for the tax years 1970, 1971 and 1972. A trial was held before the United States Tax Court and on September 24, 1984, the Tax Court filed its Findings of Fact and Opinion. *Church of Scientology of California* v. *Commissioner*, 83 T.C. 381 (1984) (App. B). The court sustained the validity of the statutory notice and held that

[3] Unrebutted church witnesses and evidence established that the September 7, 1972 policy letter was cancelled two days later. HCO PL 9 September 1972 (Ex. 274; RT 8838-39). The September 9 cancellation, signed by Mr. Hubbard, stated that he would refuse any repayments made pursuant to the September 7 letter. The money received pursuant to the September 7, 1972 policy letter was deposited in an OTC account for the benefit of the Church, a fact corroborated by IRS Agent Eugene Endo. *See* RT 7201 *et seq.*, 7585 *et seq.*, Exs. HD, HF. Monies received after the cancellation, which were also refused by Mr. Hubbard, were directed to the Hubbard Freedom Foundation, created in 1972 for exempt religious purposes.

the Church was not tax-exempt, although it was properly organized for exemption, because (1) it practiced its religion in a commercial manner; (2) part of its net earnings inured to the benefit of private individuals; and (3) it operated at variance with public policy because some church members conspired to impede the collection of taxes from the Church.

The court entered its decision for the Commissioner (CR 228) on March 6, 1985, pursuant to Tax Ct. R. 155, determining tax deficiencies, and 25% additions to tax under Section 6651(a)(1) for filing returns as a tax-exempt organization, in the total amount of $1,295,564.22.[4]

On appeal, the court of appeals affirmed the Tax Court only on the ground that the Church had failed to establish that no part of its net earnings inured to the benefit of any private individual. It did not reach the questions of whether the Church operated for a substantial commercial purpose or whether it violated public policy (App. A11-12).

Following the Tax Court, the court of apppeals identified "two indicia of inurement, overt and covert" (App. A15). The appeals court found evidence of overt inurement in payment of royalties to Mr. Hubbard and evidence of covert inurement in alleged "unfettered control" by Mr. Hubbard over Church assets and in alleged debt repayments to him (App. A20). It concluded that the "cumulative effect" of these indicia demonstrated inurement (App. A20).

With regard to the issue of royalties, the court of appeals acknowledged both that "a church may pay the author reasonable compensation in the form of royalties for his literary works" and that financing church operations

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[4]

Taxable Year	*Tax*	*Addition to Tax*
1970	$581,245.29	$145,311.32
1971	34,162.81	$ 8,540.70
1972	421,043.28	105,260.82

through the sale of religious literature "does not necessarily violate the requirements for tax exemption" (App. A16). Yet the court held the royalties paid supported a finding of inurement because "the Church encouraged its staff members to market aggressively his products," *i.e.*, Mr. Hubbard's religious writings and recordings, and because, pursuant to Church policy, "a number of publications copyrighted by L. Ron Hubbard were actually written by Church employees" (App. A16).

The first leg of the court's covert inurement finding was Mr. Hubbard's alleged "unfettered control" over Church assets in OTC and Trust accounts. The court focussed both on the Hubbard's access to these accounts, which allegedly lasted throughout the years in issue, and the transfer of assets from these accounts to the *Apollo*, which occurred only in 1972 (App. A16-17).

The court also acknowledged the lack of any evidence of misuse of the funds brought to the ship, but found inurement because of the church's alleged failure to present evidence affirmatively disproving any private use (App. A17-18). The court rejected an analogy to numerous pastors and ministers across America who collect money every Sunday morning and hold it in their unfettered control for church purposes, but whose churches are not required to disprove private use in order to retain their tax exemptions (App. A17). The asserted distinction the court drew was that here the Church funds were placed under the control of "a private individual who had no official responsibility for managing church assets" (App. A17). It is unclear from the opinion whether the "private individual" referred to was Mr. or Mrs. Hubbard.

The alleged debt repayments to Mr. Hubbard constituted the second leg of the court's covert inurement finding. The court generally referred to "debt repayments" allegedly made in the 1950s and 1960s, but the only evidence of actual payments made to which the court could cite were payments totalling $19,324.41 made between Oc-

tober 9, 1972 and December 28, 1972 pursuant to the September 7, 1972 policy letter (App. A18).

The court rejected the Church's contention that this evidence—relating only to four months during 1972—was an improper basis to support revocation of tax exemption for three separate and distinct tax years (App. A19). The court also held the payment of the $19,324.41 was evidence of inurement even if, as the evidence showed, the money was placed in an OTC account and there was no evidence of personal use of it, merely because Mr. Hubbard had unfettered access to the acount (App. A19).

The court also held that the notice of deficiency was constitutionally and administratively sound and that the late filing penalties were valid (App. A20-25).

Reasons for Granting the Writ

I.

The Court of Appeals' Royalty Finding Threatens the Religious Rights of Religious Organizations Which Must Proselytize Vigorously to Communicate Their Religious Message and Whose Internal Religious Procedures Require Religious Writings to Be Copyrighted to Particular Religious Authorities.

The court of appeals' analysis of the royalty issue utilizes Section 501(c) to punish the Church for engaging in its constitutionally protected rights to proselytize its religion through sale of its religious scriptures and to structure its internal religious affairs as it sees fit. As a result, the court's ruling places in jeopardy the rights of all religious organizations, particularly newer organizations, which must proselytize vigorously to communicate their religious message to the public and whose internal policies may be unorthodox by the standards of mainstream religions.

On the one hand, the court recognized that church sale of religious literature—even financing church operations through such sales—not only does not violate, *per se*, the requirements for tax exemption under § 501(c)(3), but that it often *furthers* the exempt religious purpose of churches. "Churches, especially less established ones, rely on the distribution of church literature to propagate their faith." (App. A16). The court further acknowledged that "a church may pay the author reasonable compensation in the form of royalties for his literary works." *Id.* The benefits that accrue to the author in such circumstances, like the benefits that accrue to church employees who are paid reasonable salaries, are deemed incidental to the charitable religious purpose which is furthered by the Church's acts of distributing and selling its religious literature or employing staff or clergy to carry out its functions. *See A.A. Allen Revivals, Inc.* v. *Commissioner*, 22 T.C.M. (CCH) 1435, 1444 (1963); *St. Germain Foundation* v. *Commissioner*, 26 T.C. 648, 658 (1956).

In reaching its conclusion that, in this case, the royalty payments nevertheless "cross the line between reasonable and excessive" (App. A16), the court did *not* find that the royalty percentages or the actual amounts paid in royalties were unreasonable, in themselves. Indeed, the court could not make such a finding, since, in the statutory notice, the IRS quite properly accepted these payments as reasonable ordinary and necessary business expenses of the Church. Rather, the court relied on two factors other than the rate or amount of royalty payments: (1) "The Church encouraged its staff members to market aggressively [Mr. Hubbard's] products [*i.e.*, his religious books]"; and (2) "a number of publications copyrighted by L. Ron Hubbard were actually written by Church employees." *Id.* Reliance on either of these factors unconstitutionally intrudes on the rights of all religious organizations, particularly newer ones, to proselytize by the sale of religious books and to freely structure their own internal religious affairs.

A. *The Court's Holding That a Church's "Aggressive" Efforts to "Market" Its Founder's Religious Works Which Constitute the Scriptures of the Religion, Together With the Church's Payment of Concededly Reasonable Royalties, Constitutes Inurement Seriously Compromises the Rights of All Religious Organizations to Proselytize by Selling Religious Literature.*

A church's efforts to aggressively distribute its scriptures by definition furthers its exempt religious purpose under the statute, and is, of course, protected activity under the First Amendment. *Murdock* v. *Pennsylvania*, 319 U.S. 105, 108-110 (1943); *Martin* v. *City of Struthers*, 319 U.S. 141, 143-47 (1943); *Schneider* v. *State*, 308 U.S. 147 (1939).

And the sale of that literature, rather than its free distribution, is likewise constitutionally protected, and likewise furthers the church's exempt purpose by raising money to support the Church's ongoing and evangelical programs.

> [T]he mere fact that the religious literature is "sold" by itinerant preachers rather than "donated" does not transform evangelism into a commercial enterprise. If it did, then the passing of the collection plate in church would make the church service a commercial project. The constitutional rights of those spreading their religious beliefs through the spoken and printed words are not to be gauged by standards governing retailers or wholesalers of books. The right to use the press for expressing one's views is not to be measured by the protection afforded commercial handbills. It should be remembered that the pamphlets of Thomas Paine were not distributed free of charge. It is plain that a religious organization needs funds to remain a going concern. But an itinerant evangelist however misguided or intolerant he may be, does not become a mere book agent by selling the Bible or religious tracts to help defray his expenses or to sustain him. Free-

> dom of speech, freedom of the press, freedom of religion are available to all, not merely to those who can pay their own way.

Murdock v. *Pennsylvania*, 319 U.S. at 111.

The court's reliance on the Church's "marketing" of Mr. Hubbard's "products" to support revocation of exemption contradicts these principles to which the court professed allegiance. It cannot be emphasized too strongly that the "products" at issue were nothing less than the Scriptures of the Scientology religion (RT 476-79). The religion of Scientology is based *solely* on the written and recorded spoken words of Mr. Hubbard and Scientology can be studied only through these writings. *See* RT 8821. It is to these writings that every Scientologist must be directed if he or she is to derive the benefits of the religion (Ex. 24-X, Vol. IV, pp. 141-42, 190). Thus dissemination of these writings is the only way the religion can be propagated, and the Church's religious mission is effectively blocked if obstacles are erected to reduce access to these writings. In seeking to evangelize in this way, the Church is no different than many religions, such as the Mormons, Christian Scientists, Jehovah's Witnesses and others. Aggressive promotion may be the only method by which a relatively new religious group may communicate its message to those "glad to receive it." *Martin* v. *City of Struthers*, *supra*, 319 U.S. at 144.

While the sale of religious literature did result in the payment of royalties to Mr. Hubbard, the court properly acknowledged that churches may pay reasonable royalties (as they may pay reasonable salaries) without losing tax exemption. Since neither the IRS nor the court assert that the royalty payments to Mr. Hubbard were excessive in percentage or dollar amount, the court's conclusion that they are rendered "excessive" by reason of the Church's aggressive proselytization efforts directly burdens and punishes the Church for engaging in such activities, which

are in furtherance of its charitable (religious) purpose and are constitutionally protected. The court somehow found conduct warranting revocation in the combination of activities protected under the Constitution and reasonable under the statute.[5] By doing so, the court's opinion violates the statute and fundamentally infringes upon the free exercise rights of the Church and its members, and opens the way for similar infringements of other religious groups.

A burden on the free exercise of religion is imposed when a government benefit is conditioned on abandonment of constitutionally protected religious rights. *Hobbie* v. *Unemployment Appeals Commission*, 107 S.Ct. 1046, 1048-50 (1987); *Thomas* v. *Review Board*, 450 U.S. 707, 716 (1981). Such a burden is constitutionally invalid unless the government can show that it is necessary to accomplish an overriding governmental interest "of the highest order." *Sherbert* v. *Verner*, 374 U.S. 396, 406 (1963).

The burden on free exercise rights created by the court is clear. The Church—and any other churches with living founders or spiritual leaders who have written the church's scriptures—will be denied tax exempt status merely because it exercises its right to proselytize aggressively by the sale of its scriptures unless the founder or spiritual

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[5] The court's holding is predicated on the argument that the reason the Church actively promoted the sale of its scriptures was for the purpose of enriching Mr. Hubbard (App. A16). This not only is contradicted by the record, which reflects the religious reasons for the Church's practices, but it is belied by subsequent events. Since Mr. Hubbard's death in January 1986, the Church has increased its efforts to distribute and sell his religious works, as is reflected by the fact that Mr. Hubbard's seminal work, *Dianetics*, has been on the Publisher's Weekly and/or New York Times best-seller lists for paperbacks for over one year, and presently ranks as number two on both lists. *See Publishers Weekly*, February 12, 1988, Trade Paperback list (74 weeks on list); *New York Times Book Review*, February 14, 1988, Miscellaneous Paperback list (40 weeks on list). The Church's efforts since Mr. Hubbard's death obviously cannot benefit Mr. Hubbard, but instead corroborate petitioner's showing that the purpose of its efforts is to disseminate widely the teachings of the religion.

leader forfeits his right to reasonable royalties. A governmental interest in denying a spiritual leader the enjoyment of reasonable royalties does not nearly rise to the level necessary to justify infringement of the Church's constitutional right to aggressively proselytize, including by the sale of its religious scriptures.

The distinction the court's standard creates among religious points out another constitutional defect. The standard has the fundamentally unfair consequence of reserving Section 501(c)(3) exemption for well established religious organizations which no longer need to proselytize aggressively in order to communicate their religious message or whose leaders are long dead and whose scriptural writings have entered the public domain and hence can financially "benefit" no one. Such a result is contrary to Section 501(c)(3), *see Presbyterian & Reformed Publishing Co.* v. *Commissioner*, 743 F.2d 148, 159 (3d Cir. 1984) (rejecting "inequitable disparity in treatment [under Section 501(c)(3)] for [religious] publishers associated with [older] mainstream churches as opposed to [younger] small offshoots"), and would violate the Church's right to the equal treatment with other religions, *Larson* v. *Valente*, 456 U.S. 228, 244 (1982), and to equal protection of the laws. *Fowler* v. *Rhode Island*, 345 U.S. 67 (1953).

The court's standard inevitably fosters excessive administrative entanglement with and interference in church practices and procedures in violation of the Establishment Clause. Excessive administrative entanglement is a necessary result of the adoption of the court's standard, under which the IRS would be authorized and required to engage in a "comprehensive, discriminating, and continuing state surveillance" of the aggressiveness of a church's promotion of its religious scriptures. *See Lemon* v. *Kurtzman*, 403 U.S. 602, 619 (1971).

Even more constitutionally disturbing is the fact that the court's standard would create state interference with the internal policies and beliefs of churches. *See Serbian*

Eastern Orthodox Diocese v. *Milivojevich*, 426 U.S. 696, 713 (1976). Decisions regarding what and how to proselytize reflect religious doctrine and decisionmaking. The decision to aggressively promote the writings of Mr. Hubbard reflects the doctrinally-based view, common to numerous religions, that the religion can be understood fully only through study of the scriptural writings of the religion's founder. RT 8821; Ex. 24-X, Vol. IV, pp. 141-42, 190. The threat of losing tax exemption if these writings are too aggressively promoted therefore pressures a church to replace its own religious-based choices with those dictated by the IRS.

Finally, the vagueness of the court's standard also leaves a church in a quandry as to what it must do to protect its exemption. What constitutes "aggressive" marketing of scriptures? How much "aggressive" marketing is permissible? Must a church seek approval for the amount, degree, scope and content of its proselytization efforts? How closely will the IRS scrutinize a church's religious proselytization efforts to assure itself that it is not acting too aggressively in seeking to spread its message and raise capital for its ongoing work and expansion?

Merely asking these questions demonstrates the impenetrable thicket created by the court's decision. With all due respect, we suggest that the court did not adequately analyze the unconstitutional nature and effect of its unprecedented standard for church proselytization. The proper test is and must be whether the payment of royalties was inflated beyond commercially reasonably percentages, not whether and to what extent the Church chose to aggressively distribute, for sale or otherwise, its religious scriptures. Under the proper test, the royalty payments were reasonable and cannot constitute inurement. As long as the court of appeals' test remains effective, the rights of all religious organizations to proselytize through the sale of religious literature copyrighted to their founders or leaders is placed in jeopardy.

B. *The Court's Finding That the Copyrighting of Books by Others to the Founder of a Religion Is Evidence of Inurement Is an Unconstitutional Intrusion Into Churches' Internal Affairs.*

The court of appeals' second reason for finding the payment of royalties to be evidence of inurement was that Mr. Hubbard held copyrights on works which were written by others. The decision to copyright all texts on a particular religion to its founder is an important internal religious doctrine.[6] Interference with this arrangement trenches on a church's rights under the Religious Clauses. First, it violates free exercise rights because it revokes the benefit of tax exemption specifically because a church engages in a particular religious-mandated practice. Since there is no private benefit involved,[7] there is no compelling government interest justifying this intrusion on free exercise. Withdrawal of tax exemption because the Church copyrights others' works to Mr. Hubbard similarly violates the Establishment Clauses' proscription on governmental interference with churches' internal policies and practices. *Serbian Eastern Orthodox Diocese* v. *Milivojevich*, *supra*, 426 U.S. at 713.

While the court's holding turns only upon the fact that works of others were *copyrighted* to Mr. Hubbard (App. A16), the court's statement of facts suggests that Mr.

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[6] In the case of this Church, there were compelling reasons, incident to the Church's religious purposes, for copyrighting works in Mr. Hubbard's name. As he was the source of all Scientology scriptures and recognized as such, the copyrights in his name gave an authoritative imprimatur to the works, thereby both ensuring orthodoxy and increasing public acceptance of the works. The benefit to the Church in carrying out and propagating its religious mission and practices from the copyrights in Mr. Hubbard's name is therefore very significant.

[7] There is simply no private benefit to Mr. Hubbard in having works written by other Scientologists copyrighted to him if he derives no royalties from them. This practice is not in any conflict with Section 501(c)(3).

Hubbard received royalties on two books written by others, "Know Your People," by Ruth Mitchell and "How to be Successful," by Peter Gillum. (App. A9). That suggestion, upon which the court of appeals did not rely in reaching its holding, was clearly erroneous: the record shows that the Church did not pay Mr. Hubbard any royalties on the two books in question.[8] Indeed, the Tax Court carefully did not contend that Mr. Hubbard received royalties on these two books (App. B114).[9] Thus, this case squarely presents the question whether it violates churches' rights under the Religion Clauses to treat as evidence of inurement the mere copyrighting of others' works to a religion's founder, in accordance with religious doctrine.

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[8] The record in this case includes a complete list of the works on which the Church paid royalties during the relevant years. *See* Stip. No. 2 (CR 50) at ¶ 6 and Exhibit 3. The two specified books were not contained on that list. Although he held the copyrights to these works, Mr. Hubbard received no royalties from the Church for them and therefore received no private benefit compromising the Church's tax exempt status.

[9] The only work referred to by the Tax Court or the court of appeals which contained material not written by Mr. Hubbard for which the Church paid him royalties was the OEC, the nine-volume set of Policy Letters which was part of the scriptures of Scientology. The record reflects that the overwhelming bulk of the material in the OEC was written by Mr. Hubbard. Material which others wrote was derivative of Mr. Hubbard's works. There was no evidence in the record that sales of the OEC were increased because it contained material written by Church employees other than Mr. Hubbard. To the contrary, the only reasonable inference is that Scientologists bought the OEC because it contained definitive policy statements of Mr. Hubbard, the founder of the religion and the source of the religion's tenets. Royalties were paid only on the OEC volumes, not on the individual policy letters. RT 2616-17. The fact that a small portion of the OEC Policy Letters were written by other people cannot, standing alone, support a finding that Mr. Hubbard was deriving substantial royalties from the work of other people.

II.

The Finding That Mere "Unfettered Control" by a Church's Religious Leader Is Evidence of Inurement Is an Unprecedented Departure From the Consistent Interpretation of the Statute and Unconstitutionally Authorizes the Internal Revenue Service to Intrude Into the Internal Affairs of Church Management.

The court of appeals' finding that a religious leader's mere control over church assets is evidence of inurement is an unprecedented interpretation of the statute, at odds with prior IRS rulings and court decisions. Even more importantly, the court's finding necessarily results in the violation of churches' rights under the Religion Clauses because it requires the IRS first to engage in excessive administrative surveillance of the internal structure and organizations of churches to determine how a church manages its funds and then to draw distinctions, determining a church's entitlement to tax exemption, based on how the church has chosen to manage those funds.

The court of appeals found evidence of inurement in the facts that Mr. and Mrs. Hubbard had access to and control over Church funds in OTC and Trust accounts and that three million dollars was transferred to the Church's headquarters on the *Apollo* in 1972, where it was placed in the custody of Mrs. Hubbard, a high Church official, who kept it under lock and key.

Numerous mainstream churches, however, similarly place millions of dollars of church funds in the unfettered control of their religious leaders. Yet until now these churches have never faced a presumption—which they must affirmatively disprove or lose their exemptions—that these leaders' mere control over these funds is evidence of inurement. Rather, both the IRS and the Tax Court have held consistently that an individual's control of a church or other

charitable organization and its assets will not preclude exemption under Section 501(c)(3) and that there must be evidence of specific transactions in which the individual actually used his or her position for private benefit before exemption can be lost. The Service's own published position for over 20 years specifically states that control alone will not preclude exemption:

> An organization, which otherwise meets the requirements for qualification for exemption from Federal income tax as an organization described in section 501 (c)(3) of the Internal Revenue Code of 1954, will not be precluded from establishing an exempt status under section 501(a) of the code merely because the creator of the organization (if a trust) is either the sole or controlling trustee or merely because the organization is controlled by one individual. . . .

Revenue Ruling 66-219, 1966-2 C.B. 208. In 1971, the General Counsel of the IRS reiterated that the "basic legal principles expressed in Rev. Rul. 54-243 [1954-1 C.B. 92] and Rev. Rul. 66-219 are correct" and that "the mere existence of a control relationship" is "no basis" for denying exemption. G.C.M. 34443 (March 3, 1971).

The IRS has specifically recognized that there must be specific conduct reflecting private benefit—a transaction in addition to control—to preclude exemption. In discussing control of an organization by its founder, the IRS stated:

> By the same token unless the [transactions between the founder and the organization] . . . can be utilized to establish an 'inurement of earnings to the benefit of private individuals' argument, the fact that this organization is controlled by members of the same family or even by one individual, is immaterial.

G.C.M. 32246 (April 4, 1962).

The courts also require that control be combined with a specific act before exemption can be threatened and that there be hard evidence of the act—not just speculation. In *St. Germain Foundation* v. *Commissioner*, 26 T.C. 648 (1956), for example, the Tax Court rejected the Service's argument that the mere control of the Board of Directors, without evidence of wrongdoing, was somehow significant:

> It is true, as respondent indicates, that Edna W. Ballard and Betty O. Mundy, as two of the three members of the board of directors, were in control of the activities of the petitioner both in matters of religious instruction and in financial matters. We do not see the significance of this, however, where such control, by the majority of the board of directors, is exercised to carry out the avowed religious purposes of the petitioner and where such control is not employed, *so far as the evidence and the record as a whole reveal*, to channel net earnings of the petitioner to private shareholders or individuals.

26 T.C. at 60 (emphasis supplied).

Likewise, in *Church of the Visible Intelligence that Governs the Universe* v. *United States*, 4 Cl. Ct. 55 (Ct. Cl. 1983), the Court of Claims rejected similar allegations concerning "totalitarian powers" held by the organization's founder for lack of evidence:

> An organizational structure like plaintiff's entailing domination by the founder raises concern about the potential for abuse unless allayed by other information in the record. But domination does not necessarily disqualify an organization from exemption. The regulations impose no limits on the powers a tax exempt organization grants its officers, they only require that it be operated for public rather than private purposes. *If there was any evidence in the record to support defendant's interference of private benefit, the court would be troubled by Rutherford's powers.*

Id. at 62 (citations omitted; emphasis supplied). *See also Broadway Theatre League, Inc.* v. *United States*, 293 F. Supp. 346, 354 (W.D.Va. 1968) (the "mere possibility" of control by booking agent "should not be enough to deny the organization an exemption").

The court of appeals was unable to point to any evidence of a specific act inconsistent with exemption. To the contrary, the evidence in the record—the accountant's testimony that he counted the money on the ship after the years in issue and found none missing—supports the conclusion that there was no private inurement.

The court discounted this evidence,[10] and instead focussed on the alleged failure of the Church to *prove the absence* of private use. But a church may be required to disprove private benefit only when there is evidence of a specific transaction suggesting inurement. See discussion, *supra*. Thus, the court's attempt to place this burden on the Church is unprecedented and the cases relied on (App. A19-20) are inapposite.[11]

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[10] The court found that this evidence "proved nothing" because it was "not inconsistent" with the Tax Court's finding that Mr. Hubbard had unfettered control of Church funds (App. A18). Since control alone is insufficient to negate exempt status, it is the court's point which proves nothing.

[11] In *Parker* v. *Comm'r*, 365 F.2d 792, 799 (8th Cir. 1966), the court placed the burden of explaining "unidentified withdrawals" from a church account on the taxpayer, where he had made withdrawals and "commingled" personal and church funds. The withdrawals here from OTC and Trust accounts were completely identified and the funds were placed in the ship's safe, without any evidence of commingling or personal use.

The other cases relied on also all involve actual payments to church leaders. In *Bubbling Well Church of Universal Love* v. *Comm'r*, 670 F.2d 104, 105 (9th Cir. 1981), the court held that members of a family, who were the sole employees and sole voting directors of a church, were required to produce evidence of the services they rendered the Church in exchange for actual payments made. Similarly, in *Founding Church of Scientology* v. *United States*, 412 F.2d 1197, 1201-02 (Ct. Cl. 1969), *cert. denied*,

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The court of appeals' finding necessarily results in equally unprecedented unconstitutional intrusions into the internal affairs of religious organizations and distinctions among and between religious organizations.

Religious leaders of various denominations have absolute control of millions of dollars in church funds without being required to detail and justify their use of these assets. Every Sunday ministers and pastors across the country collect money from parishioners and hold it in their unfettered control for church purposes. The court found comparison of ministers' unfettered control of church funds to the facts of this case unpersuasive because "here the Church transferred millions of dollars to bank accounts controlled by a private individual who had no official responsibility for managing church assets" (App. A17).

The attempted distinction must fail for two reasons. First, as a factual matter, it was *Mrs.* Hubbard who had direct control of and access to the funds on the ship, and she *did* have official responsibility for managing church assets. She was the Controller of the Church.

Second, and more fundamentally, even if it were Mr. Hubbard who controlled the funds, it is plainly unconstitutional for the government to engage in the surveillance of churches necessary to determine who holds assets in a church, and equally unconstitutional to draw distinctions

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397 U.S. 1009 (1970), the court held that the plaintiff had the burden to justify payments made to individuals "in the nature of loans, reimbursements for expenditures in plaintiff's behalf, for expenses and other purposes."

Thus, unlike the instant case, the cited cases involved transactions involving actual payments to private individuals. By requiring the taxpayers to justify these payments, the courts were operating within the authority of case law and service rulings permitting a finding of private inurement where control is combined with a specific additional act. *See* discussion, *supra*. There is no such additional act here.

for tax purposes based upon whether the person in control holds a formal corporate position of leadership, as opposed to an untitled position of spiritual leadership.

The inquiry necessary for the government to determine which individuals within a church control its assets and whether those individuals have "official responsibility for managing church assets" requires excessive administrative entanglement of the government in church affairs. The surveillance needed would have to be both comprehensive, since only extensive disclosure would reveal true control and responsibility of church officials, and continuing, since there would be a continuing presumption of inurement from the mere fact of control. *See Lemon* v. *Kurtzman*, *supra*, 403 U.S. at 619.

Under the court's analysis, after ascertaining a church's practices regarding control of funds, the IRS is then authorized and required to further intrude into religious organizations' decisionmaking by granting or denying tax exemption based on whether the organization places its assets in the hands of individuals with "official responsibility for managing church assets" or not. Different religions make different, religiously-based decisions regarding the management and control of their assets. *See* 50 N.Y. Jur. Religious Societies § 111 at 11:

> The polity or organizational system and customs of the particular religious denomination may have an important bearing upon the matter of the property powers, rights, or interests of a local church of that denomination, whether incorporated or unincorporated. In some denominations of churches, title to all or much of the church property (including that of the local churches) is taken and held by the general or central church organization or certain of its authorities. Under the Roman Catholic church system, title to church property ordinarily is vested in the bishop of the diocese, and is by him transmitted to his successor.

(Footnotes omitted). The fact that the Catholic Church vests title to its property in individuals rather than church organizations could arguably justify a presumption of inurement absent proof that there was no private benefit. Under the court of appeals' ruling, the Catholic Church could be required to affirmatively disprove private benefit or lose its exemption. But the Catholic Church's choices regarding control of its assets are the product of religious doctrine. And to disfavor that Church specifically because its doctrines dictate a particular form of financial management would unconstitutionally pressure it, in order to ensure a tax exemption, to replace its own internal ecclesiastically-based policies and organization with ones which conforms to the IRS's preferences. Governmental pressure of this kind unconstitutionally intrudes on a church's right to order its internal affairs. *Serbian Eastern Orthodox* v. *Milivojevich, supra.* In addition, to favor or disfavor particular churches in terms of tax exempt status merely on the basis of whether or not a church entrusts its assets to the type of official the court of appeals prefers creates an unconstitutional denominational preference.

In this particular case, it is clear constitutional violation to find "unfettered control" evidence of inurement merely because the Church placed its assets in the control of its highest ecclesiastical leader rather than in the hands of someone with "official responsibility for managing church assets" (App. A17). The very idea that the IRS may deny tax exemption status on the ground that a church places its assets in the control of the individual who provides its spiritual direction and leadership is an affront and threat to the religious liberty of all churches.

It is apparent from the discussion above that the court's finding of covert inurement by reason of "unfettered control" must fall for constitutional and statutory reasons.

The second finding of covert inurement based on alleged debt repayments is integrally tied to the "unfettered con-

trol" issue, and for this reason must also be reversed. The only finding of actual debt repayment which the court made was limited to a four-month period in 1972. The court found that between October 9 and December 28, 1972, $19,324.41 in debt repayments were made. Uncontroverted evidence established that these funds were not paid to Mr. Hubbard, who refused them. Instead, as was corroborated at trial by IRS agent Endo, they were deposited in an OTC account for the benefit of the Church. There is no evidence of any private use of these funds by Mr. Hubbard. Thus, as the court of appeals ultimately acknowledged (App. A19), these funds are evidence of inurement *only* if Mr. Hubbard's mere control of the accounts is evidence of inurement. As shown above, mere access and control is insufficient to establish inurement.[12]

III.

Certiorari Is Appropriate Because, Due to the Court of Appeals' Reliance on the "Cumulative Effect" of Three Alleged Indicia of Inurement, Reversal of the Court's Holding as to Any of These Indicia for Any of the Tax Years at Issue Requires a New Trial.

The court of appeal's finding of inurement rested on the "cumulative effect" of three factors: royalties as an indicium of over inurement and "unfettered control" of Church assets and "debt repayments" as indicia of covert inurement (App. A20). Given the court's explicit reliance on the joint effect of these three indicia, it is apparent that the entire finding must fall if even one of these indicia is held not to support a finding of inurement.

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[12] The court of appeals' conclusion that OTC and the Trust were shams was based on the fact that Mr. Hubbard had access to and control of funds in OTC accounts. But if, as shown here, mere access and control are not evidence of inurement, then the finding that OTC and the Trust were shams must fall.

If the royalty finding is reversed, a remand would be necessary to determine whether the evidence of covert inurement alone is sufficient to avoid reversal of the entire inurement holding. Similarly, if the "unfettered control" finding is reversed—and such a reversal would necessarily require reversal of the "debt repayment" finding, as demonstrated above—a remand would be necessary to determine whether the royalty finding alone could support the inurement holding.

The necessity of a new trial is heightened by the fact that for some of the years in issue there is no evidence of one or more of the court's indicia of inurement. Each tax year is a separate cause of action and involves separate liability. *Commissioner* v. *Sunnen*, 333 U.S. 591, 598 (1948). The court of appeals failed to consider the fact that its three indicia of inurement were not applicable to all three tax years and therefore failed to consider separately for each year whether there was sufficient evidence to support a finding of inurement.

There is no evidence whatsoever that Mr. Hubbard received royalties from the Church in 1970, *see* Stip. No. 2 (CR 50) and App. B48. The Commissioner's only evidence of debt repayments collected allegedly for Mr. Hubbard was the $19,324.41 recorded as having been collected between October 9, 1972 and December 28, 1972, in response to the September 7, 1972 policy letter.[13] There is no evi-

[13] The Tax Court and court of appeals cited no specific evidence that debt repayments were made in 1970 or 1971. Instead, they relied on the asserted facts that Mr. Hubbard had been paid a portion of gross income of Scientology churches in the 1950's and tithes, known by several different names, in the 1960's (App. A18), and concluded on the basis of the September 7, 1972 policy letter that "[t]hese loan repayments continued into the docketed years." It is doubtful that the documents from the 1960s could support a finding of inurement since none of them refer to actual sums paid. But even if they did, they cannot be combined with

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dence of debt repayments for 1970 or 1971, and this indicium must be excluded from any evidence of inurement for these years. Thus, for the tax year 1970, the only evidence of inurement on which the court's holding can rest is Mr. Hubbard's "unfettered control" of OTC and Trust accounts. For 1971, there is only evidence of control of these accounts and the payment of royalties.[14]

It is thus clear that review by this Court of the fundamental constitutional and statutory issues raised by this petition will be outcome determinative of this case. If this Court reverses the court of appeals holdings on either the royalties questions or the unfettered control question, the judgment must be reversed and the case remanded for a new trial.

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the 1972 letter to support a legal finding of inurement for 1970 and 1971. This is particularly true since the September 7, 1972 letter reflects an effort to institute such payments because they were not being made. The letter further states that where payments had been made, they were not received by Mr. Hubbard but were invoiced and used by Scientology organizations (App. B117).

[14] To the extent the court's finding of "unfettered control" rests on the transfer of assets to the safe on the *Apollo*, rather than on Mr. Hubbard's general access to the OTC and Trust accounts, it can be evidence of inurement only as to 1972. If the transfer of the assets to the ship is the basis of the unfettered control finding, then there is absolutely no evidence of inurement for 1970 and only the payment of royalties for 1971.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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